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033303X/88

5 October 1988

MEMORANDUM FOR: Deputy Director of Central Intelligence

VIA: Acting Deputy Director for Intelligence

FROM: [redacted] 25X1
Director, Office of European Analysis

SUBJECT: Proposed Talking Points on G-7 Trade Imbalances

1. Action recommended: That you discuss a forthcoming EURA IA with General Powell at your weekly meeting with him. Proposed Talking Points are attached, and the IA will be sent to you tomorrow. [redacted] 25X1

2. On Tuesday, October 11, CPAS will distribute a EURA IA that projects a worsening US current accounts deficit beginning around 1990, a development with grave implications for the dollar and US interest rates but that could be avoided by greater policy coordination among the G-7 countries. This judgment, although shared by a number of outside economists, goes against the rosier views of some in the Administration and is likely to be controversial. In order to forewarn key officials of our views, we propose to go by the following schedule:

- Thursday, October 6: You discuss the IA with General Powell.
- Friday, October 7: A synopsis appears in the PDB and the PDB briefers have with them a copy of the IA to give to interested PDB recipients.
- Tuesday, October 11: CPAS begins regular distribution of the IA. [redacted] 25X1

3. We will be glad to discuss the issue further with you, if you desire. [redacted] 25X1

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Attachment:
Proposed Talking Points

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SUBJECT: Proposed Talking Points on G-7 Trade Imbalances

Distribution

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5 October, 1988

Draft Talking Points: Adjustment of Trade Imbalances

The Agency's world economic model, which has been in operation for over 10 years, suggests that good news on the trade front may not last much longer. The narrowing of the US current account deficit as well as the Japanese surplus probably will continue next year, but at a slower pace than in 1988.

- o The US current account deficit will probably decline in 1989, but only by a fraction of the $25 billion improvement expected this year.
- o We do not expect the Japanese surplus to fall much from its $75 billion level and the West German surplus will probably rise somewhat from $40 billion, unless GNP growth in these two countries turns out to be substantially higher than we expect.

Our model indicates that by 1990 the stimulus from the dollar's decline in 1985-87 will be mostly gone. If the US economy keeps growing at a normal rate, the current account deficit will start to widen again.

- o By 1992 -- assuming steady growth and no change in exchange rates -- the US deficit would be over $200 billion.
- o Under these circumstances the Japanese surplus would be well over $100 billion and the German surplus would approach $100 billion.

We doubt that foreigners would lend us the $200 billion to finance this deficit at existing interest rates, so either the dollar would have to fall or US interest rates would have to rise, or both. This adjustment could be gradual, with the dollar falling smoothly over a long period. But this cannot be predicted with any confidence. It is also possible that the adjustment will be sharp and painful, as a result of soaring interest rates and a collapsing stock market.

Our model also shows that policy coordination with our allies could help us avoid a potentially painful market-driven adjustment. Prospects for coordinating such action effectively now seem dim, however, largely because the short-term economic outlook in the G-7 countries remains favorable and because the allies view the trade imbalances primarily as a US problem.

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